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No. 240

In the Supreme Court of the United States

OCTOBER TERM, 1960

C. D. SPANGLER AND VEVA C. SPANGLER, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. 16a–39a) are reported at 32 T.C. 782. The opinion of the Court of Appeals (Pet. 47a–60a) is not yet officially reported.

JURISDICTION

The judgment of the Court of Appeals was entered on April 18, 1960. (Pet. 47a.) The petition for certiorari was filed on July 15, 1960. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

QUESTION PRESENTED

Whether the record supports the concurrent holdings below that two corporations in which taxpayer[1]

[1] References to the taxpayer are to petitioner C. D. Spangler. His wife is a party only because joint returns were filed.

was a stockholder were collapsible corporations within Section 117(m) of the Internal Revenue Code of 1939, and that consequently gain realized by him upon the redemption of some of his stock in the corporations was taxable as ordinary income rather than as capital gain.

STATUTES AND REGULATIONS INVOLVED

The relevant statutes and Regulations, Section 117 (m) of the Internal Revenue Code of 1939, Section 212(b), Revenue Act of 1950, c. 994, 64 Stat. 906, and Section 29.117.11 of Treasury Regulations 111 are set out in the Appendix, *infra*, pp. 14–30.

STATEMENT

The facts, as stipulated and as found by the Tax Court (Pet. 16a–30a), may be summarized as follows:

On February 28, 1949, the Federal Housing Commissioner entered into a commitment for mortgage insurance in the amount of $2,233,700, repayable over a period of about 33 years, for a rental housing project to be built in Charlotte, North Carolina. A mortgagee bank was named therein, the taxpayer, C. D. Spangler, was designated as the sponsor, and the mortgagor was Double Oaks Apartments, Inc. (Double Oaks), a proposed or prospective corporation. (Pet. 17a.)

Double Oaks was organized under the laws of the State of North Carolina on May 10, 1949. Its authorized capital stock consisted of Class A common having a par value of $1 per share, Class B common with a par value of $100 per share, and preferred stock having a par value of $1 per share. (Pet. 18a.)

On June 10, 1949, Double Oaks issued stock for cash at par as follows (Pet. 19a):

Type of stock	Number of shares	Name in which issued
5% Preferred	100	Federal Housing Administration.
A Common	300	C. D. Spangler Construction Company.
A Common	100	Fred L. Taylor.
B Common	2,194.01	William G. Lyles, Bissett, Carlisle and Wolf (Architects).
B Common	156.4	C. D. Spangler Construction Company.
B Common	750	Fred L. Taylor.

Fred L. Taylor, who resides at Pinehurst, North Carolina, is not related by either blood or marriage to the taxpayer and in 1949 and theretofore was not an employee of either the taxpayer or Construction Company. On or about January 26, 1950, the 750 shares of Class B common stock originally issued to him were acquired by Construction Company for $75,000. On May 24, 1950, Construction Company surrendered this stock to Double Oaks for redemption and received therefor $75,000 in cash. On or about November 2, 1950, the 100 shares of Class A common stock originally issued to Fred L. Taylor were redeemed for $100. (Pet. 19a–20a.)

William G. Lyles, Bissett, Carlisle and Wolf was an architectural firm which maintained its principal office at Columbia, South Carolina. The F.H.A. project analysis and commitment for Double Oaks contemplated that architect fees in the amount of $112,376 and builders' fees in the amount of $107,025, or a total of $219,401, would be paid in stock. The 2,194.01 shares of Double Oaks Class B common stock, representing the aggregate architect and builders' fees was originally issued to the architects. On Au-

gust 8, 1949, such 2,194.01 shares were sold to the taxpayer for the amount of $16,570. (Pet. 20a.)

Construction of the housing project began on or about June 10, 1949. On that date Double Oaks entered into a contract with Construction Company under which the latter agreed to build the project for a lump sum of $2,140,493. The contract provided that the taxpayer should give an indeninity agreement in the amount of $223,370 to assure completion of the project. Such total amount was paid in several payments by Double Oaks over the period from June, 1949 to January 1950. After all the payments were made, Construction Company paid Double Oaks on May 24, 1950, an amount of $171,239.44 as a refund on the construction contract. (Pet. 22a.)

Some of the units were ready for occupancy in November 1949. Double Oaks collected, during the fiscal years ended May 31, 1950, and May 31, 1951, rents in the respective amounts of $115,308.99 and $230,012.77. Double Oaks made the first payment of principal on its $2,233,700 loan on or about December 1, 1950. During the fiscal years ended May 31, 1950, and May 31, 1951, it paid interest on such loan in the respective amounts of $62,766.45 and $81,771.44. (Pet. 22a.)

On May 24, 1950, the taxpayer surrendered 1,844.01 shares of Class B common stock of Double Oaks to that corporation for redemption and received in exchange therefor the amount of $184,401 in cash. On December 20, 1950, he surrendered an additional 350 shares of Class B common stock for redemption and

received in exchange therefor the amount of $35,000 in cash. The total of 2,194.01 shares so surrendered and redeemed were the same 2,194.01 shares that he had purchased from William G. Lyles, Bissett, Carlisle and Wolf on August 8, 1949, at a cost of $16,570. (Pet. 22a-23a.)

At June 30, 1950, and June 30, 1951, Double Oaks had no accumulated earnings and profits. Its tax returns were filed on an accrual basis. For the fiscal years ended May 31, 1950, and 1951, the returns showed net operating losses of $19,980.36 and $65,354.44, respectively. Its returns for subsequent years through June 30, 1957, also showed net losses except for a small profit in one short period. (Pet. 23a.)

Some time prior to February 28, 1950, the taxpayer sponsored a second housing project at Charlotte, North Carolina. Newland Road Apartments, Inc., hereinafter referred to as Newland Road, was organized under the laws of the State of North Carolina on March 15, 1950, for the purpose of carrying out this project. (Pet. 24a.)

The authorized capital of Newland Road was $300,000 divided into 100,000 shares of Class A common stock with a par value of $1 per share, 1,999 shares of Class B common stock with a par value of $100 per share; and 100 shares of five per cent noncumulative preferred stock with a par value of $1 per share. (Pet. 25a.)

On April 1, 1950, Newland Road issued stock for cash as follows (Pet. 25a):

Type of stock	Number of shares	Name in which issued
Preferred	100	Federal Housing Administration.
A Common	300	C. D. Spangler Construction Co.
B Common	148.03	William G. Lyles, Bissett, Carlisle and Wolf (Architects).

As in the case of Double Oaks, the taxpayer was the sponsor of the Newland Road project, and the F.H.A. committed itself to loan $824,000. (Pet. 25a.)

The F.H.A. project analysis and commitment for Newland Road contemplated that architects' fees in the amount of $44,803 and builders' fees in the amount of $42,670, or a total of $87,473, would be paid. As indicated above, 148.03 shares of Newland Road Class B common stock were originally issued to the architects. On May 26, 1950, Newland Road paid the architects $3,220 in cash; and on May 29, 1950, the taxpayer purchased the 148.03 shares for $1,000. (Pet. 25a.)

On April 1, 1950, Newland Road obtained a loan from a bank in Charlotte, North Carolina, in the amount of $824,000 which was evidenced by a promissory note. (Pet. 26a.)

On or about April 1, 1950, Newland Road began construction of the rental housing project. On that date Construction Company entered into a contract to construct the buildings for a lump sum of $758,413, or cost plus $15,000, whichever was lower, and in addition 726.70 shares of the Class B common stock of the corporation. (Pet. 27a.)

Some units in the project were ready for occupancy in July 1950, and from the date of first occupancy to December 1950, the rents collected by Newland Road amounted to $35,258.45. (Pet. 27a.)

On December 20, 1950, the taxpayer surrendered 148.03 shares of Class B common stock of Newland Road to that corporation for redemption and received in exchange therefor the amount of $14,803 in cash. The shares so surrendered and redeemed were the same shares that he had purchased from William G. Lyles, Bissett, Carlisle and Wolf on May 29, 1950, at a cost of $1,000. (Pet. 27a.)

At December 31, 1950, Newland Road had no accumulated earnings and profits. Its tax returns were filed on an accrual basis. For the fiscal year ended December 31, 1950, the return showed net operating losses of $3,579.55. Its returns for subsequent years through June 30, 1957, also showed net losses. (Pet. 27a–28a.)

In their joint income tax return for the year ended December 31, 1950, the taxpayers reported long-term capital gain of $202,831 from the redemption of the Class B common stock of Double Oaks and $13,803 from the redemption of the Class B common stock of Newland Road. (Pet. 28a.) The Commissioner in his deficiency notice determined that the gains were taxable as ordinary income under Section 22(a) of the Internal Revenue Code of 1939, and in an amended answer filed more than two months before the trial in the Tax Court he set out as an additional reason in support of the deficiency that the taxpayers realized ordinary income under Section 117(m). (Pet. 28a–29a.)

The Tax Court, in an opinion reviewed by the full court, unanimously held that Double Oaks and New-

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land Road were "collapsible corporations" as defined in Section 117(m), and that the gains were therefore taxable as ordinary income. It also rejected the taxpayer's contention that the basis of the stock redeemed should be increased. (Pet. 33a, 39a.) Taxpayer's motions to amend his petition so as to allege unconstitutionality of Section 117(m), and to vacate the Tax Court's decision and for a "further trial" on that alleged ground, were denied. (Pet. 41a–46a.) The Court of Appeals affirmed. (Pet. 47a–60a.)

ARGUMENT

The court below, in an opinion by Chief Judge Sobeloff, meticulously examined each of the various contentions advanced by the taxpayer, and found them to be unsupported by the facts of record and the applicable provisions of law. There is no conflict of decisions or other reason for further review of the case. The redemption distributions here involved—consisting of the excess proceeds of FHA insured mortgage loans over the cost of construction—are the very type Section 117(m) was designed to cover, and in a series of similar cases the lower courts have uniformly held the statute to be applicable. *Burge* v. *Commissioner*, 253 F. 2d 765, 767 (C.A. 4th); *Weil* v. *Commissioner*, 252 F. 2d 805 (C.A. 2d); *Glickman* v. *Commissioner*, 256 F. 2d 108 (C.A. 2d); *Sorin* v. *Commissioner*, 271 F. 2d 741 (C.A. 2d); *Sidney* v. *Commissioner*, 273 F. 2d 928 (C.A. 2d); *Abbott* v. *Commissioner*, 258 F. 2d 537 (C.A. 3d); *August* v. *Commissioner*, 267 F. 2d 829 (C.A. 3d); *Payne* v. *Commissioner*, 268 F. 2d 617 (C.A. 5th). Each of the

arguments which taxpayer asserted below, and renews here, has been rejected in one or more of those cases.

1. Taxpayer's principal contention (Pet. 7–12) is that, one of the three redemption distributions here involved having been made on May 24, 1950, prior to the approval date of Section 117(m) on September 23, 1950,[2] the provisions of that section may not be retroactively applied to that distribution.[3] As the court below pointed out (Pet. 56a), this objection could have been but was not raised at the trial. In any event, as the court below also held (Pet. 56a), the contention is without merit. Section 117(m) was added to the Code by the Revenue Act of 1950, in response to the request of the President by a message dated January 23, 1950, to close a tax loophole which permitted individuals by use of the collapsible corporation device "to take unfair advantage of the difference between the tax rates on ordinary income and the lower rates on capital gains."[4] Under prior law,

[2] Section 117(m) was added to the Internal Revenue Code of 1939 by Section 212 of the Revenue Act of 1950, c. 994, 64 Stat. 906, approved September 23, 1950.

[3] Two distributions were made by Double Oaks, the first on May 24, 1950, the other on December 20, 1950. (Pet. 22a–23a.) One distribution was made by Newland Road on December 20, 1950. (Pet. 27a.) Although two of the three distributions occurred after the enactment of Section 117(m), the petition speaks only of the previous one.

[4] Message from the President of the United States transmitting Request for a Revision of the Tax Laws (January 23, 1950), H. Doc. No. 451, 81st Cong., 2d Sess., p. 5. See also 1 House Hearings on Revenue Revision of 1950, p. 70; H. Rep. No. 2319, 81st Cong., 2d Sess., pp. 56–57, 96–99 (1950–2 Cum. Bull. 380, 422–423, 449–451); S. Rep. No. 2375, 81st Cong., 2d Sess., pp. 88–89 (1950–2 Cum. Bull. 483, 546–548).

taxpayers who utilized a corporation to construct or manufacture property were able to extract their anticipated profits from the enterprise at capital gain rates by selling or redeeming their stock, or receiving a distribution from the corporation, before the corporation had realized a substantial part of the anticipated net income. Internal Revenue Code of 1939, Section 115 (c) and (d). To prevent that result, Congress enacted Section 117(m), which treats stockholder gains on distributions from a "collapsible corporation" as ordinary income, and defines a collapsible corporation as one—

> formed or availed of principally for the manufacture, construction, or production of property * * * with a view to (i) the sale or exchange of stock by its shareholders * * * or a distribution to its shareholders, prior to the realization by the corporation * * * of a substantial part of the net income to be derived from such property, and (ii) the realization by such shareholders of gain attributable to such property.

By Section 212(b) of the Revenue Act of 1950, Section 117(m) was made applicable to gain realized after December 31, 1949. Notwithstanding that the gain in question was realized after that date (May 1950), taxpayer insists that the statute is being applied retroactively, in violation of the due process clause, because it was not finally approved until September 23, 1950. The court below, agreeing with the Second Circuit's decision in *Sidney* v. *Commissioner*, 273 F. 2d 928, properly rejected the contention. The statute does not include new items in income, but

merely excludes certain previously taxed items from the benefit of capital gain treatment. "The distribution in the instant case was of a sort long subject to Federal income taxation; § 117(m) changed the law only as to the category of income and consequently the rate." *Sidney* v. *Commissioner, supra,* p. 932. See also *Welch* v. *Henry,* 305 U.S. 134, 147.[5]

2. Equally untenable is taxpayer's contention (Pet. 12–15) that the implementing Treasury Regulations (Sec. 29.117–11 of Regulations 111 (Appendix, *infra,* pp. 16–30) transcend the provisions of Section 117(m) by treating as ordinary income gains from corporate distributions which previously had been taxable as capital gains under Section 115(d). The Regulations are in complete harmony with the broad provisions of Section 117(m) and their legislative history, and have been sustained by every court which has passed upon their validity. At any rate, the decision here need not turn on the interpretative Regulations; it is sustained by the statutory provisions themselves, to say nothing of the explanatory Committee Reports.[6] See *Burge* v. *Commissioner, supra; Weil* v. *Commissioner, supra; Payne* v. *Commissioner, supra,*

[5] Furthermore, contrary to taxpayer's assertion (Pet. 11) that the change could not have been anticipated when the May 1950 distribution was made, it was generally known that the President had requested the change and that it was under active consideration by Congress. See footnote 4, *supra*; *Sidney* v. *Commissioner, supra.*

[6] Contrary to taxpayer's assertion (Pet. 13), the Committee Reports specifically state that Section 117(m) was intended to cover distributions which were previously taxable as capital gains under Section 115(d). See S. Rep. No. 2375, *supra,* p. 89 (1950–2 Cum. Bull. 483, 547).

Abbott v. *Commissioner, supra; Sorin* v. *Commissioner, supra.* Taxpayer's contention that the collapsible corporation provisions do not apply to corporate distributions which would otherwise fall within Section 115(d) disregards the express "but for" proviso of Section 117(m)(1), and its underlying purpose as explained in the Committee Reports. It is unsupported by any decision, and was properly rejected by the court below on the basis of the "very language" of the statute. (Pet 58a.)

3. Nor is there substance in taxpayers' contention (Pet. 15–17) that the stock redemption gains which they admittedly realized and here seek to treat as capital gains are not taxable as ordinary income under Section 117(m) merely because the distributing corporations' operations might eventually turn out to be unprofitable. The collapsible corporation provisions are expressly aimed at gains realized by stockholders from distributions made "prior to the realization by the corporation * * * of a substantial part of the net income to be derived" from its property, not at the actual net income of the corporation. Furthermore, they come into play whenever a corporation is "availed of * * * with a view to" making such a distribution. It suffices, as the courts below held (Pet. 35a, 54a), that at the time of the stock redemption distributions here involved, the distributing corporations had not realized substantial parts of the total net income which it was hoped would eventually be realized from their rental properties. In the words of the court below (Pet. 54a), "the statute does not require that net income from the prop-

erty should in fact subsequently develop, if the corporation has been availed of with a view to making the distribution prior to the corporation's realization of a substantial part of net income." See also *Payne* v. *Commissioner, supra; Burge* v. *Commissioner, supra.* On this score, too, no conflict exists or is alleged.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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AUGUST 1960.

APPENDIX

Internal Revenue Code of 1939:

SEC. 117. CAPITAL GAINS AND LOSSES.

* * * * *

(m) [as added by Sec. 212(a) of the Revenue Act of 1950, c. 994, 64 Stat. 906] *Collapsible Corporations.*—

(1) *Treatment of gain to shareholders.*—Gain from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months, shall, except as provided in paragraph (3), be considered as gain from the sale or exchange of property which is not a capital asset.

(2) *Definitions.*—

(A) For the purposes of this subsection, the term "collapsible corporation" means a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to—

(i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and

(ii) the realization by such shareholders of gain attributable to such property.

(B) For the purposes of subparagraph (A), a corporation shall be deemed to have

manufactured, constructed, or produced property, if—

(i) it engaged in the manufacture, construction, or production of such property to any extent,

(ii) it holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, or produced the property, or

(iii) it holds property having a basis determined, in whole or in part, by reference to the cost of property manufactured, constructed, or produced by the corporation.

(3) *Limitations on application of subsection.*—In the case of gain realized by a shareholder upon his stock in a collapsible corporation—

(A) this subsection shall not apply unless, at any time after the commencement of the manufacture, construction, or production of the property, such shareholder (i) owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation, or (ii) owned stock which was considered as owned at such time by another shareholder who then owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation;

(B) this subsection shall not apply to the gain recognized during a taxable year unless more than 70 per centum of such gain is attributable to the property so manufactured, constructed, or produced; and

(C) this subsection shall not apply to gain realized after the expiration of three years following the completion of such manufacture, construction, or production.

For purposes of subparagraph (A), the ownership of stock shall be determined in accordance with the rules prescribed by paragraphs (1), (2), (3), (5), and (6) of section 503(a); except that, in addition to the persons prescribed by paragraph (2) of that section, the family of an individual shall include the spouses of that individual's brothers and sisters (whether by the whole or half blood) and the spouses of that individual's lineal descendants.

* * * * *

(26 U.S.C. 1952 ed., Sec. 117.)

Revenue Act of 1950, c. 994, 64 Stat. 906:

SEC. 212. TREATMENT OF GAIN TO SHAREHOLDERS OF COLLAPSIBLE CORPORATIONS.

* * * * *

(b) *Effective Date.*—The amendment made by this section shall be applicable to taxable years ending after December 31, 1949, but shall apply only with respect to gain realized after such date. The determination of the tax treatment of gains realized prior to January 1, 1950, shall be made as if this section had not been enacted and without inferences drawn from the fact that the amendment made by this section is not expressly made applicable to gains realized prior to such date and without inferences drawn from the limitations contained in section 117(m), added to the Internal Revenue Code by this section.

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.117-11 [as added by T. D. 5999, 1953-1 Cum. Bull. 187]. *Collapsible Corpora-*

tions.—(*a*) *In general.*—With respect to taxable years ending after December 31, 1949, but only with respect to gain realized after such date, and subject to the limitations contained in (*c*) hereof, the entire gain from (1) the actual sale or exchange of stock of a collapsible corporation, (2) amounts distributed in complete or partial liquidation of a collapsible corporation which are treated, under section 115(c), as payment in exchange for stock, and (3) a distribution made by a collapsible corporation which, under section 115(d), is treated, to the extent it exceeds the basis of the stock, in the same manner as a gain from the sale or exchange of property, shall be considered as gain from the sale or exchange of property which is not a capital asset.

(*b*) *Determination of collapsible corporation.*—With respect to taxable years ending after December 31, 1949, but only with respect to gain realized after such date, a collapsible corporation is defined by section 117(m)(2)(A) to be a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to (1) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and (2) the realization by such shareholders of gain attributable to such property. With respect to taxable years ending after August 31, 1951, but only with respect to gain realized after such date, the definition of a collapsible corporation under section 117(m)(2)(A) is expanded to include a corporation formed or availed of principally for the purchase of property which (in the hands of the corporation) is property de-

scribed in section 117(a)(1)(A), or for the holding of stock in a corporation so formed or availed of, with a view to (1) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation purchasing the property of a substantial part of the net income to be derived from such property, and (2) the realization by such shareholders of gain attributable to such property.

See (*d*) of this section for a description of the facts which will ordinarily be considered sufficient to establish whether or not a corporation is a collapsible corporation under the rules of the section. See (*e*) of this section for example of the application of section 117(m).

Under section 117(m)(2)(A), the corporation must be formed or availed of with a view to the action therein described, that is, the sale or exchange of its stock by its shareholders, or a distribution to them, prior to the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the net income to be derived from such property, and the realization by the shareholders of gain attributable to such property. This requirement is satisfied in any case in which such action was contemplated by those persons in a position to determine the policies of the corporation, whether by reason of their owning a majority of the voting stock of the corporation or otherwise. The requirement is satisfied whether such action was contemplated unconditionally, conditionally, or as a recognized possibility. If the corporation was so formed or availed of, it is immaterial that a particular shareholder was not a shareholder at the time of the manufacture, construction, production, or purchase of the property, or if a shareholder at such time, did not share in such view, and any gain of such shareholder on his

stock in the corporation shall be treated in the same manner as gain of a shareholder who did share in such view. See, however, the limitation contained in (c)(2) hereof. The existence of a bona fide business reason for doing business in the corporate form does not, by itself, negate the fact that the corporation may also have been formed or availed of with a view to the action described in section 117(m)(2)(A).

A corporation is formed or availed of with a view to the action described in section 117(m)(2)(A) if the requisite view existed at any time during the manufacture, production, construction, or purchase referred to in that section. Thus, if the sale, exchange, or distribution is attributable solely to circumstances which arose after the manufacture, construction, production, or purchase (other than circumstances which reasonably could be anticipated at the time of such manufacture, construction, production, or purchase), the corporation shall, in the absence of compelling facts to the contrary, be considered not to have been so formed or availed of. However, if the sale, exchange, or distribution is attributable to circumstances present at the time of the manufacture, construction, production, or purchase, the corporation shall, in the absence of compelling facts to the contrary, be considered to have been so formed or availed of.

The property referred to in section 117(m)(2)(A) is that property or the aggregate of those properties with respect to which the requisite view existed. In order to ascertain the property or properties as to which the requisite view existed, reference shall be made to each property as to which, at the time of the sale, exchange, or distribution referred to in section 117(m)(2)(A), there has not been a realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the net income

to be derived from such property. However, where any such property is a unit of an integrated project involving several properties similar in kind, the determination whether the requisite view existed shall be made only if a substantial part of the net income to be derived from the project has not been realized at the time of the sale, exchange, or distribution, and in such case the determination shall be made by reference to the aggregate of the properties constituting the single project.

A corporation shall be deemed to have manufactured, constructed, produced, or purchased property if it (1) engaged in the manufacture, construction, or production of property to any extent, or (2) holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, produced, or purchased the property, or (3) holds property having a basis determined, in whole or in part, by reference to the cost of property manufactured, constructed, produced, or purchased by the corporation. Thus, under (1), for example, a corporation need not have originated nor have completed the manufacture, construction, or production of the property. Under (2), for example, if an individual were to transfer property constructed by him to a corporation in exchange for all of the capital stock of such corporation, and such transfer qualifies under section 112(b)(5), then the corporation would be deemed to have constructed the property, since the basis of the property in the hands of the corporation would, under section 113(a)(8), be determined by reference to the basis of the property in the hands of the individual. Under (3), for example, if a corporation were to exchange property constructed by it for property of like kind constructed by another person, and such exchange qualifies under section 112(b)(1), then the corporation would be deemed

to have constructed the property received by it in the exchange, since the basis of the property received by it in the exchange would, under section 113(a)(6), be determined by reference to the basis of the property constructed by the corporation.

In determining whether a corporation is a collapsible corporation by reason of the purchase of property, it is immaterial whether the property is purchased from the shareholders of the corporation or from persons other than such shareholders. The property, however, must be property which, in the hands of the corporation, is property of a kind described in section 117(a)(1)(A). Section 117(a)(1)(A) describes the following property: stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. The determination whether property is of a kind described in section 117(a)(1)(A) shall be made without regard to the fact that the corporation is formed or availed of with a view to the action described in section 117(m)(2)(A).

Section 117(m) is applicable whether the shareholder is an individual, a trust, an estate, a partnership, a company, or a corporation.

(e) *Limitations on application of section.*—(1) *General.*—This section shall apply only to the extent that the recognized gain of a shareholder upon his stock in a collapsible corporation would be considered, but for the provisions of this section, as gain from the sale or exchange of a capital asset held for more than 6 months. Thus, if a taxpayer sells at a gain stock of a collapsible corporation which he has held for 6 months or less, this section would not, in any event, apply to such gain. Also, if it is determined, under provisions of law other

than section 117(m), that a sale or exchange at a gain of stock of a collapsible corporation which has been held for more than 6 months results in ordinary income rather than long-term capital gain, then this section (including the limitations contained herein) has no application whatsoever to such gain.

(2) *Stock ownership rules.*—This section shall apply in the case of gain realized by a shareholder upon his stock in a collapsible corporation only if the shareholder, at any time after the actual commencement of the manufacture, construction, or production of the property, or at the time of the purchase of the property described in section 117(a)(1)(A) or at any time thereafter, (i) owned, or was considered as owning, more than 10 percent in value of the outstanding stock of the corporation, or (ii) owned stock which was considered as owned at such time by another shareholder who then owned, or was considered as owning, more than 10 percent in value of the outstanding stock of the corporation.

The ownership of stock shall be determined in accordance with the rules prescribed by section 503(a) (1), (2), (3), (5), and (6), except that, in addition to the persons prescribed by section 503(a)(2), the family of an individual shall include the spouses of that individual's brothers and sisters, whether such brothers and sisters are by the whole or the half blood, and the spouses of that individual's lineal descendants.

For the purpose of this limitation, treasury stock shall not be considered as outstanding stock.

It is possible, under this limitation, that a shareholder in a collapsible corporation may have gain upon his stock in that corporation treated differently from the gain of another shareholder in the same collapsible corporation.

(3) *Seventy-percent rule.*—This section shall

apply to the gain recognized during a taxable year upon the stock in a collapsible corporation only if more than 70 percent of such gain is attributable to the property referred to in section 117(m)(2)(A). If more than 70 percent of such gain is so attributable, then all of such gain is subject to this section, and, if 70 percent or less of such gain is so attributable, then none of such gain is subject to this section.

For the purpose of this limitation, the gain attributable to the property referred to in section 117(m)(2)(A) is the excess of the recognized gain of the shareholder during the taxable year upon his stock in the collapsible corporation over the recognized gain which the shareholder would have if the property had not been manufactured, constructed, produced, or purchased. In the case of gain on a distribution in partial liquidation or a distribution described in section 115(d), the gain attributable to the property shall not be less than an amount which bears the same ratio to the gain on such distribution as the gain which would be attributable to the property if there had been a complete liquidation at the time of such distribution bears to the total gain which would have resulted from such complete liquidation.

Gain may be attributable to the property referred to in section 117(m)(2)(A) even though such gain is represented by an appreciation in the value of property other than that manufactured, constructed, produced, or purchased. Where, for example, a corporation owns a tract of land and the development of one-half of the tract increases the value of the other half, the gain attributable to the developed half of the tract includes the increase in the value of the other half.

(4) *Three-year rule.*—This section shall not apply to that portion of the gain of a shareholder that is realized more than 3 years after the actual completion of the manufacture, con-

struction, production, or purchase of the property to which such portion is attributable.

(*d*) *Application of section.*—(1) Whether or not a corporation is a collapsible corporation shall be determined under the rules of (*b*) of this section on the basis of all the facts and circumstances in each particular case. The following paragraphs set forth those facts which will ordinarily be considered sufficient to establish that a corporation is or is not a collapsible corporation. The facts set forth in the following paragraphs are not exclusive of other facts which may be controlling in any particular case. For example, if the facts in paragraph (2), but not the facts in paragraph (3), are present, the corporation may nevertheless not be a collapsible corporation if there are other facts which clearly establish that the rules of (*b*) of this section are not satisfied. Similarly, if the facts in paragraph (3) are present, the corporation may nevertheless be a collapsible corporation if there are other facts which clearly establish that the corporation was formed or availed of in the manner described in (*b*) of this section, or if the facts in paragraph (3) are not significant by reason of other facts, such as the fact that the corporation is subject to the control of persons other than those who were in control immediately prior to the manufacture, construction, production, or purchase of the property.

See (*c*) of this section for provisions which make section 117(m) inapplicable to certain shareholders of collapsible corporations.

(2) The following facts will ordinarily be considered sufficient (except as otherwise provided in paragraph (1), above, and paragraph (3), below) to establish that a corporation is a collapsible corporation:

(i) A shareholder of the corporation sells or exchanges his stock, or receives a liquidating distribution, or a distribution described in section 115(*d*),

(ii) Upon such sale, exchange, or distribution, such shareholder realizes gain attributable to the property described below, and

(iii) At the time of the manufacture, construction, production, or purchase of the property described below, such activity was substantial in relation to the other activities of the corporation which manufactured, constructed, produced, or purchased such property.

The property referred to above is that property or the aggregate of those properties which meet the following two requirements:

(iv) The property is manufactured, constructed, or produced by the corporation or by another corporation stock of which is held by the corporation, or is property purchased by the corporation or by such other corporation which (in the hands of the corporation holding such property) is property described in section 117(a)(1)(A) (relating to stock in trade, inventories, and property held primarily for sale to customers), and

(v). At the time of the sale, exchange, or distribution described in (i) above, the corporation which manufactured, constructed, produced, or purchased such property has not realized a substantial part of the net income to be derived from such property.

In the case of property which is a unit of an integrated project involving several properties similar in kind, the rules of this paragraph shall be applied to the aggregate of the properties constituting the single project rather than separately to such unit. Under the rules of this paragraph, a corporation shall be considered a collapsible corporation by reason of holding stock in other corporations which manufactured, constructed, produced, or purchased the property only if the activity of the corporation

in holding stock in such other corporations is substantial in relation to the other activities of the corporation.

(3) The absence of any of the facts set forth in paragraph (2) or the presence of the following facts will ordinarily be considered sufficient (except as otherwise provided in paragraph (1), above) to establish that a corporation is not a collapsible corporation:

(i) In the case of a corporation subject to the rules of paragraph (2) only by reason of the manufacture, construction, production, or purchase (either by the corporation or by another corporation the stock of which is held by the corporation) of property which is property described in section 117(a)(1)(A), the amount (both in quantity and value) of such property is not in excess of the amount which is normal—

(A) For the purpose of the business activities of the corporation which manufactured, constructed, produced, or purchased the property if such corporation has a substantial prior business history involving the use of such property and continues in business, or

(B) For the purpose of an orderly liquidation of the business if the corporation which manufactured, constructed, produced, or purchased such property has a substantial prior business history involving the use of such property and is in the process of liquidation.

(ii) In the case of a corporation subject to the rules of paragraph (2) with respect to the manufacture, construction, or production (either by the corporation or by another corporation the stock of which is held by the corporation) of property, the amount of the unrealized net income from such property is not substantial in relation to the amount of the net income realized

(after the completion of a material part of such manufacture, construction, or production, and prior to the sale, exchange, or distribution referred to in paragraph (2)(i) from such property and from other property manufactured, constructed, or produced by the corporation.

(*e*) *Examples.* The following examples will illustrate the application of this section:

Example (*1*). On January 2, 1951, A formed the W Corporation and contributed $50,000 cash in exchange for all of the stock thereof. The W Corporation borrowed $900,000 from a bank, the loan being insured by the Federal Housing Authority, and used $800,000 of such sum in the construction of an apartment house on land which it purchased from $50,000. The apartment house was completed on December 31, 1951. On December 31, 1951, the corporation, having determined that the fair market value of the apartment house, separate and apart from the land, was $900,000, made a distribution (permitted under the applicable state law) to A of $100,000. At this time, the fair market value of the land was $50,000. As of December 31, 1951, the corporation has not realized any earnings and profits. In 1952, the corporation began the operation of the apartment house and received rentals therefrom. The corporation has since continued to own and operate the building. The corporation reported on the basis of the calendar year and cash receipts and disbursements.

Since A received a distribution and realized a gain attributable to the building constructed by the corporation, since, at the time of such distribution, the corporation has not realized a substantial part of the net income to be derived from such building, and since the construction of the building was a substantial activity of the corporation, the W Corporation is considered a collapsible corporation under (*d*)

(2) of this section. The provisions of section 117(m)(3) do not prohibit the application of section 117(m)(1) to A. Therefore, the distribution, if and to the extent that it may be considered long-term capital gain rather than ordinary income without regard to section 117 (m), will be considered ordinary income under section 117(m)(1).

In the event of the existence of additional facts and circumstances in the above case, the corporation, notwithstanding the above facts, might be considered a collapsible corporation. See (*b*) and (*d*)(1) of this section.

Example (2). On January 2, 1950, B formed the X Corporation and became the sole shareholder thereof. This corporation completed the construction of an office building in 1950. Immediately after the completion of the building, the corporation sold this building at a gain of $50,000, included this entire gain in its return for 1950, and distributed this entire gain (less taxes) to B. The corporation completed the construction of a second office building in June 1951. In August 1951, B sold the entire stock of the X Corporation at a gain of $12,000, which gain is attributable to the second building. In view of the fact that B sold stock of the X corporation and realized a gain attributable to the second office building, that, at the time of such sale, the corporation had not realized a substantial part of the net income to be derived from such building, and that the construction of such building during the time of such construction was a substantial activity of the corporation, the X Corporation is considered a collapsible corporation under (*d*)(2) of this section. Since the provisions of section 117(m)(3) do not prohibit the application of section 117(m)(1) to B, the gain of $12,000 to B is, accordingly, considered ordinary income.

Example (3). The facts in this example are the same as in example (2), except that the

following facts are shown: B was the president of the X Corporation and active in the conduct of its business. The second building was constructed as the first step in a project of the X Corporation for the development for rental purposes of a large suburban center involving the construction of several buildings by the corporation. The sale of the stock by B was caused by his retiring from all business activity as a result of illness arising after the second building was constructed. Under these additional facts, the corporation is not considered a collapsible corporation. See (*b*) and (*d*)(1) of this section.

Example (*4*). On January 2, 1947, C formed the Y Corporation and became the sole shareholder thereof. The Y Corporation has been engaged solely in the business of producing motion pictures and licensing their exhibition. On January 2, 1952, C sold all of the stock of the Y Corporation at a gain. The Y Corporation has produced one motion picture each year since its organization and prior to January 2, 1952, it has realized a substantial part of the net income to be derived from each of its motion pictures except the last one made in 1951. This last motion picture was completed September 1, 1951. As of January 2, 1952, no license had been made for its exhibition. The fair market value on January 2, 1952, of this last motion picture exceeds the cost of its production by $50,000. A material part of the production of this last picture was completed on January 1, 1951, and between that date and January 2, 1952, the corporation had realized net income of $500,000 from other motion pictures produced by it. The corporation has consistently distributed to its shareholder its net income when received (after adjustment for taxes).

Although the corporation is within (*d*)(2) of this section with respect to the production of property, the amount of the unrealized net in-

come from such property ($50,000) is not substantial in relation to the amount of the net income realized, after the completion of a material part of the production of such property and prior to sale of the stock, from such property and other property produced by the corporation ($500,000). Accordingly, the Y Corporation is within (*d*)(3)(ii) of this section, and is not considered a collapsible corporation.

Example (*5*). The facts are the same as in example (*4*) except that C sold all of his stock to D on February 1, 1951. On January 2, 1952, D sold all of the Y Corporation stock at a gain, the gain being attributable to the picture completed September 1, 1951, and not released by the corporation for exhibition. In view of the change of control of the corporation, the provisions of (*d*)(3)(ii) are not significant at the time of the sale by D, and the Y Corporation would be considered a collapsible corporation on January 2, 1952. See (*b*) and (*d*)(1) of this section.